DOW THEORY LETTERS INC.

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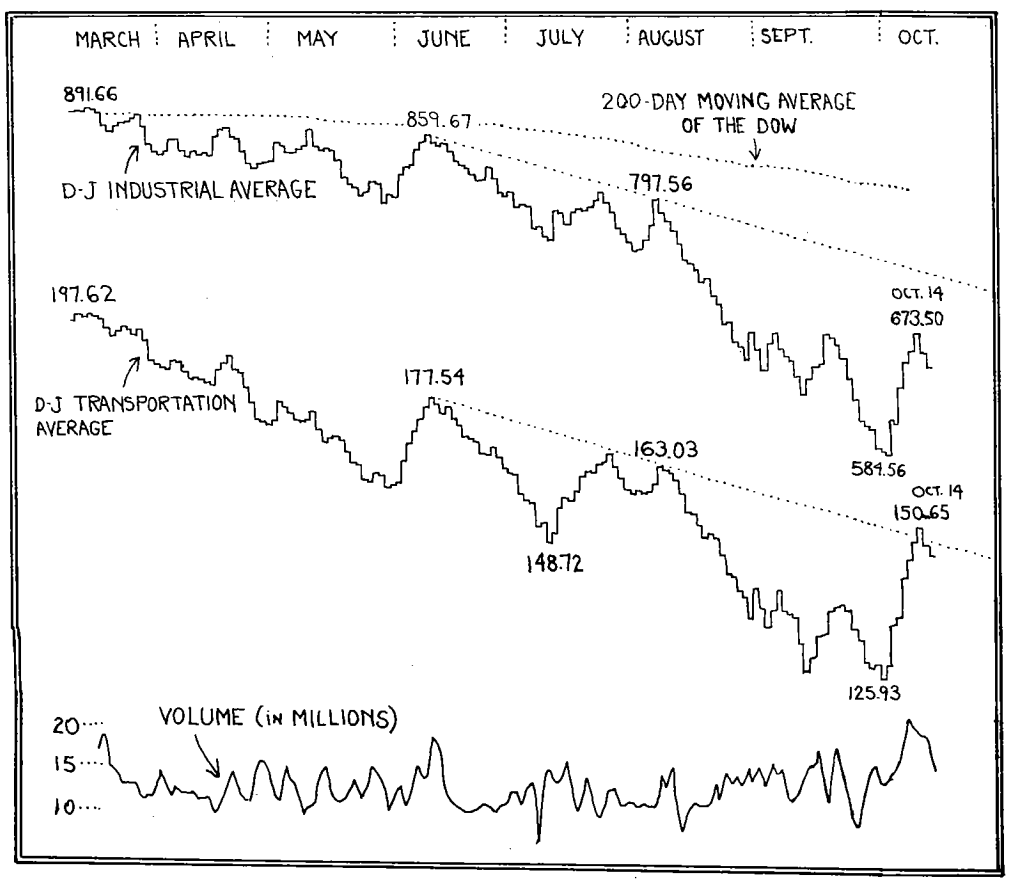
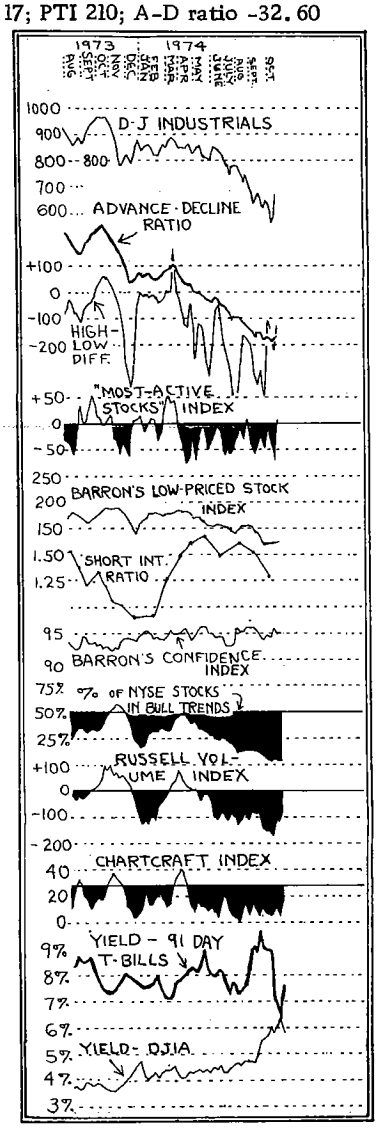
October 18, 1974 Letter 612

WORLD PICTURE: (1) Starvation across middle Africa, India, much of Asia. (2) Western Europe and the US without any effective leadership, living for decades far beyond their means, now losing wealth at an unprecedented rate to (3) oil producing nations, who are now gaining wealth in what amounts to the greatest transfer of assets in history. (4) Chances of recycling oil money is slim. Arabs (like any sane businessmen) want assets for assets, will not continue to sell their assets for paper. Arabs' answer to the West, "We've lived in tents for decades while you fattened up on our energy resources (oil) purchased at depression prices. You've been living too high, and you've got to cut back to reality." (5) Result will be deflation in the US and the West, and a coming dramatic slashing of living standards.

THINGS TO COME: Cutting back in the face of a 2½ trillion dollar debt overhang (this is just the US debt) implies collapse. Therefore, I see (1) a coming panic to get liquid in the US and the West. After 25 years of being told that we should "borrow, hold no cash, owe everyone because we can pay back later with cheaper dollars," the nation has finally placed itself in the perfect "ready-for-perpetual-inflation stance" — we're loaned-up to the hilt. Now the cards are slowly being called; the West is being eaten alive by high costs and sky-high interest charges. For instance, it requires $200 billion of new, external capital annually in the US just to keep the nation standing still! The result is going to be an absolutely unprecedented rush for cash (a rush for cash with which to stave off bankruptcy). This rush should be followed by a second rush to move large amounts of cash into gold-related items as the pressing need for a giant boost in the price of gold becomes obvious.

THE PICTURE: Did you hear about President Ford? He was overheard telling Treasury Secretary





Simon that his September 8, anti-inflation program was just "a rehearsal," and the following is what he is going to demand after elections. First, a 25% across-the-board cut in all wages, salaries, remunerations. Second, a 25% cut in all prices, everything from wheat to egg-beaters, from autos to plywood. Third, a national "Use Less" program showing people how they can save material, oil, food, etc. He's going to form a national board with teeth in it to halt waste. No more extra wrappers and cardboard boxes at MacDonald's hamburgers, no more triple-chromed car stripping, no more throwaway merchandise. And he's going to place a huge bonus on savings. All savings up to $5,000 a year per person will be tax free (tax free dividends or

 interest). And do you know the darnedest thing of all? President Ford is copying old Charles deGaulle in that he's going to give the American people their choice; either all of his new concepts go through or he's resigning.

Above is my fantasy for the program that would end inflation instantly. President Ford wouldn't have to resign, however. He'd be impeached or declared insane within a matter of days. But inflation would really end! And if by some outlandish quirk of fate, the American people accepted Mr. Ford's new anti-inflation program, we'd be wading through galloping deflation within a matter of weeks.

"All right, Russell," the voice says, "Never mind the fantasies. Do you think President Ford's new program will stop inflation or not?" My answer is that Mr. Ford's program wouldn't stop a caterpiller. The only thing that is going to stop inflation is illiquidity, a collapsing stock market, declining business, and a US and world-wide depression. As the problems mount, as the profits and incomes drop, as we move through Fall, 1974, and into 1975, I feel that we'll see more signs of "non-inflation" with increasing signs of deflation.

I just received charts from Capital International Perspectives (15, rue du Cendrier, 1201 Geneva, Switzerland). Of 16 international wholesale price indices (showing annual rate of change), 10 are now moving down and only 6 are rising. This is a fairly sophisticated preview, but it does indicate a move from inflation towards deflation. On the annual rate of change of industrial production in 16 leading nations, I get the same kind of reading. Rate of change up in 6 countries, down in 10. This suggests the beginning of world recession.

As the business contractions become more pronounced, the various nations will seek to fight recession by relaxing whatever anti-inflation measures they have instituted up to this point. Already, we see a trend towards lower interest rates, and my latest St. Louis Federal Reserve Charts indicate that the Fed is now attempting to pump up the money supply again, although the increases probably will not show up for a period of a few weeks to a few months! Interest rates are now easing, and the prime rate is being notched downward. Fed Chairman Burns issued what seems to be a weekly statement to the effect that "there will be no credit crunch." Ah, anti-inflation, I remember him well!

From the standpoint of the big picture, we should realize that primary bear markets serve to correct the excesses of the preceding bull markets. So far in this bear market, the only corrections we have seen have occurred on Wall Street — in decimated stocks, in battered customers' accounts, and in statistics on sliding brokerage house employment. Before the next primary bull market begins, we will see Wall Street's agonies moved over to the area of the nation's economy. At the December, 1972, peak, the value of all NYSE stocks was $872 billion. The latest figure is $545 billion. You don't erase $327 billion in NYSE values alone without such losses being reflected in the economy. It's going to show up in worsening business trends, further declines in consumer confidence, and a steady squeeze in corporate profits and individual incomes. This is what I mean when I say that a bear market tends to feed on itself.

Classically, the selling of stocks, merchandise, inventories, real estate, etc., serves to build up liquidity. Savings accounts start to rise. The money coffers fill, while the will to spend the money diminishes. This is the kind of atmosphere in which primary bull markets are born. In view of the extensive decline in stock prices so far in this bear market, it is absolutely extraordinary that liquidity has failed to build up. In previous bear markets, great stock market declines have tended to leave the nation swimming in cash. What's wrong today? The answer is that we never had anything like the current debt situation. Liquidity has remained dangerously low because corporations and individuals are using all incoming money just to stay afloat. Thus, there has been no liquidity build-up, only a great sopping up of money as cash has gone towards keeping everyone's respective noses above the waterline. Frankly, there's never been anything comparable to the current phenomenon.

The lack of liquidity has given way to what historians may some day term "The Age of Recycling." This is the process by which the borrower tries to borrow back the money he spent in the first place, then spend it again. Since interest rates today are high, this process could conceivably result in an ever-rising tower of debt with the sellers (for instance, the Arabs) shipping out their real assets for the dubious satisfaction of knowing that they will ultimately control all the paper in the world. The only fly in the recycling ointment, however, is that the Arabs aren't very interested in recycling, and what they are willing to recycle seems to be parcels of 15 to 30 day prime and ultra-prime paper.

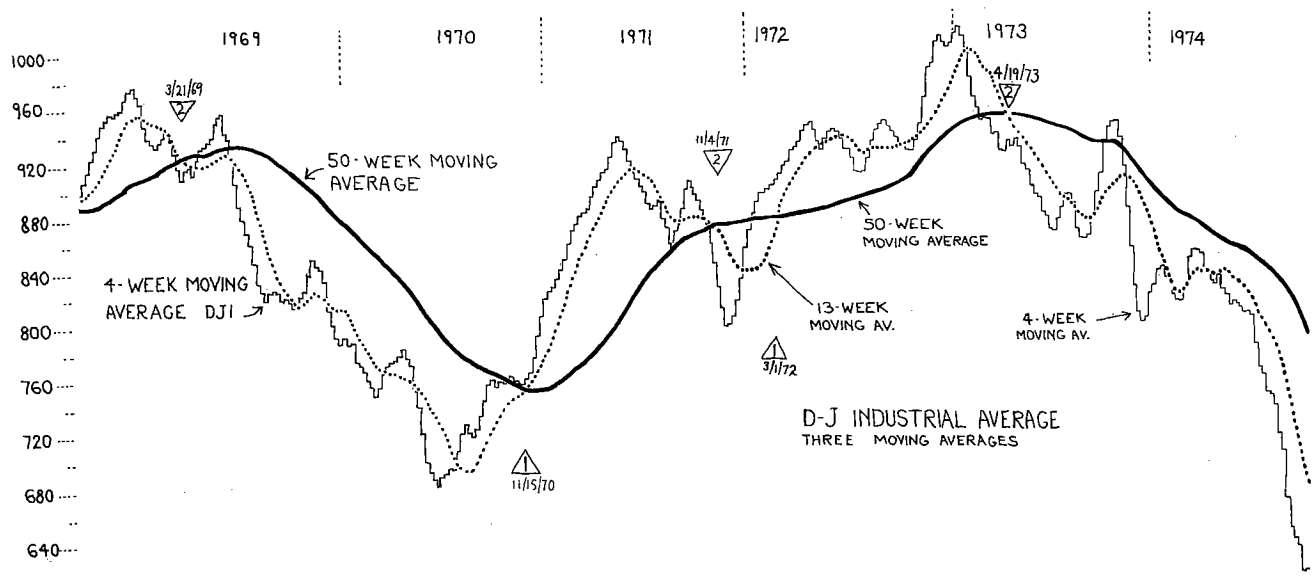
Another but subtler form of recycling is occurring in the US. For example, in an attempt to stimulate the slumping housing market, the Senate last week cleared a bill to provide up to $7.7 billion in new home mortgages with a rate ceiling of 8.25%. If the bill goes through, a Government agency will have to go out and borrow the money (at probably 9 or 10%), then loan it back to the public from which it was borrowed. And so, on into the night.....

THE MARKET: The 1929 to 1932 decline for the Dow was 381 to 41, a drop of 340 points or 89%. The drop from the 1973 Dow high of 1051.70 to the 1974 low of 584.56 was 467 points (greater than 1929-32) but of course the percentage decline was considerably less, being only 44%. If we consider that the 1974 decline from the March 14 Dow high of 891.66 to the October 4 low of 584.56 was practically a straightline drop, then the March to October collapse qualifies as the greatest uncorrected pointage smash (307 points) in stock market annals.

In view of this, it was not too surprising that the rebound from the October 4 low took the Dow up 73.61 points in a single week (week ending Oct. 11), a record for any week in Wall Street history. Volume for the same week averaged 18.9 million shares per day, above anything seen on the downside during 1974. Volume figures suggest to me that Wall Street can still get more enthusiastic about buying a bear rally than it can in unloading stocks during a primary bear market decline (I don't consider this a hopeful indication). In view of all this, the obvious question is, "What is the market saying; what do we have here?" To my mind, we have the emotional, bouncing, straight-up kind of action typical of a classic bear market rally.

It should be remembered that most of the major bear markets in history have ended with saucer bottoms, tedious sideways movements, low volume, rather than violent spike or V-shaped bottoms (such as the early-October affair). It should also be remembered that this kind of violent action, the ripping upward of prices after months of downside slaughter (1) encourages traders to rush in, (2) frightens the shorts to cover, (3) provides the specialists with an opportunity to lighten their inventories, (4) relieves the oversold technical situation, (5) Affords the perpetual bulls a chance to breath again, and even to shout for the umptieth time that "a new bull market" has been born.

In the last Letter I posed the question of whether the bear market was winding up its second phase. I am leaving this question open, but I am not at all convinced that the second phase has ended. There is alot of bad news emerging, and alot more still to come. For the benefit of last week's new subscribers, the second phase of a bear market is the psychological phase in which the market goes down as it reflects deteriorating political, social and economic conditions for corporations.



MOVING AVERAGES: Markets can do anything, and to the neophyte what the market is doing never makes sense at the moment. Therefore, a market adage worth keeping in mind is this one: "The market always does what it is supposed to — but never when." One of the charts I follow has a good record of keeping me on the right side of major bull movements and out of trouble when the major trend turns bearish. This is the chart of three moving averages (MA's) of the Dow Industrial. The 50-week MA is the long-term index, the 13-week is the intermediate-term index, and the 4-week is the short-term index. These three are plotted on the accompanying chart for the period of 1969 to date.

I use crossings of the various MA's as signals. Crossings of the 4 and 13 week MA's are simply "alert signals." But the major signals occur when the 13-week MA crosses above the 50-week MA (a bull signal), or when the 13-week MA breaks below the 50-week MA (a bear signal). Note that major signals are not given very often, only five since 1969. Note also that when a major market move occurs, the greatest part of that move (whether bull or bear) occurs after one of the MA signals.

The last signal given by this study occurred on April 19, 1973, at 963.20 on the Dow. That was a major sell signal (see chart). Since then, the Dow has dropped 379 points to the October 4 low of 584.56. Last week saw the 50-week MA at 807 while the 13-week MA stood at 698. The spread between the two was a whopping 109 points, the largest I have ever recorded.

The implications of this extraordinary point spread are two-fold, as I see it. (1) The market has been primed to rebound, much like an object which is pushed far out against a rubber band. The 13-week MA had simply plunged too far below the 50-week MA. (2) Since major signals on the MA studies are given when the 13 and 50 week MA's cross, it is clear that any forthcoming bullish signal under these studies will take a number of months (over the past 14 weeks the two MA's have moved apart at the rate of 4.7 points per week; at that same rate it would take almost four months for a recrossing). My guess is that the current upward correction will run out of steam prior to a recrossing of the 13-week MA above the 50-week MA. But we'll let the market tell its own story during the period ahead.

WHAT AUTHORITY? One of the most difficult problems one has to face in this lifetime is the problem of the father. Everyone wants a symbolic father, an authority to tell him what's happening or more importantly, what's going to happen. And one of the most terrifying (and yet strengthening) experiences is that moment, that flash in time when you realize that there is no father (or mother, for that matter) here on earth. In that instant you know that you have to be your own parent. Now I doubt that most people ever experience that concept, but those that do face a blinding truth. The truth is that the only real expert, the only great and infallible power is in heaven. Our experts here on earth are of two varieties, (1) those who are very good in some specific field, even though they can at times be very wrong, and (2) those who pretend they are very good at something, and this type usually ends by sinking into a mire of their own phoniness and lies.

What has this all got to do with the stock market? Well, I'll confess that I am one of those who has experienced the flash of reality. I have experienced the fact that I don't have a father, that I am kidding myself if I look elsewhere for a father, and that the extraordinary part of the whole drama is that I am my own parent. Again, the question, "Russell, what the devil does this have to do with the stock market?"

This is what it has to do with it. I know a fact, an absolute fact that would scare hell out of Wall Street, Washington and 95% of the nation if it ever got out. That fact is that there isn't a man alive who knows what's going to happen next month or next year. Those who pretend to know are "playing" the role of expert, or big daddy, or father. I can name alot of public, symbolic, professional fathers. They're a dime a dozen. Mr. Kissinger, Mr. Rockefeller, Mr. Rinfret, Mr. Galbraith, Mr. Getty, Miss Sylvia Porter, Dr. Spock, on and on (by the way, to my mind President Ford doesn't want to be a father and doesn't even fit the image).

What else has this got to do with the market? Well, if you think about it, it sets the stage for some rather important contrary opinions. For instance, US oil bills are jumping from $7.5 billion in 1973 to $25 billion this year. The total of the oil-consuming nations' oil bills are going to careen from an estimated $85 billion this year to $120 billion in 1975, and a theoretical $170 billion in 1980! Yet, almost every expert I know or read about says that the situation is not going to be too bad next year, that "this is no 1929," that oil prices will have to come down, that despite everything the world is on a stronger footing now than during the 1920's.

You can't prove it by me. In 1929 the US national debt was $16 billion. Today it's nearer $425 billion. That puts us on stronger footing? In 1929 the US had a seemingly endless supply of raw materials. That gift is no longer true. The US is a big raw material importer today. I could put forth many unfavorable comparisons, but my point is that we don't know, the experts don't know. Did any of the experts foresee the Dow going into the 500's in 1974? Did anyone see Polaroid going from 150 to 15?

I am in touch with men throughout the nation whom I consider to be the brightest in this field, and I also correspond with stock market professionals from every continent. Most of them (not all, but most) think that this bear market will end soon, to be followed by an even greater bull market. Will they be right? Don't bet on it. Those are only predictions. But suppose we try a contrary opinion. Suppose that this bear market slides into the high or middle 400's on the Dow, and suppose all the funds and institutions and individuals who are still holding shares (because they believed the big daddies) realize that the daddies are wrong? Suppose at about 450 or so on the Dow the insitutions realize that the experts are wrong, and the experts themselves start hedging and hemming and hawing?

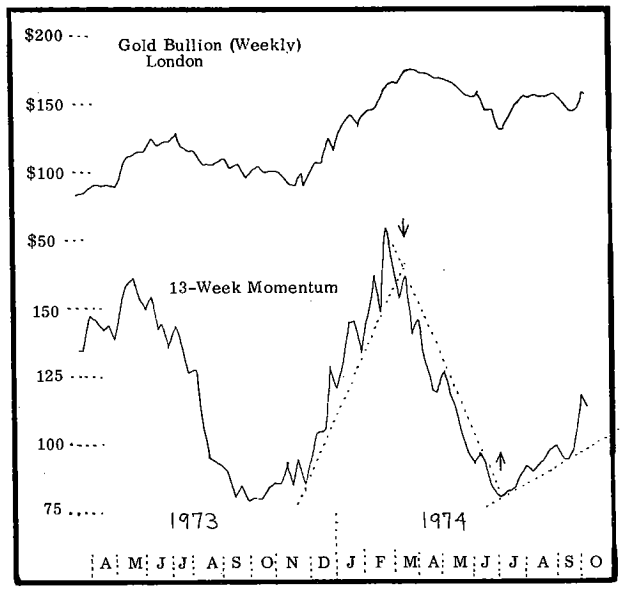
What I'm saying is this: (1) A primary bear market can do anything. (2) This is a very big bear market, it has occurred after a whopping 17-year bull market, and this bear market can certainly do anything. (3) The experts are only guessing when they predict, and I include myself here. It's actually all most experts can do to identify a new situation when it occurs, much less predict that it is going to occur.

(4) The great majority of people would much rather have numb-skull certainty than logical probabilities or well-reasoned choices. (5) The world situation is very, very serious now. The oil problem is not being solved, it will not be solved by Mr. Ford's million barrel a day cut. The inflation fiasco is not being solved. This kind of inflation always, repeat always gives way to ultimate hyper-inflation or collapse. Either outcome is obviously very bearish. (6) I believe that 90% of what we read regarding the future trend of events is pure bunk. People believe what they want to believe, and writers write what people will read. (7) The overriding fact at this time is that we are still in a great primary bear market. Under Dow Theory, the trend is taken to remain in force until proved otherwise. No "otherwise" proof has arrived yet.

I'll end this discussion by saying that I will continue to present to subscribers my own thoughts and analyses and ideas. Some of these will be based on facts, some will be based on my intuition, some will be based on my skill and experience. But if any readers are thumbing through Dow Theory Letters looking for the words of the guru or the great mind or the big daddy or the prophet, forget it. I don't want any part of those labels. I put enough work into this business already, and I don't need the pressure of someone else's fantasy-wishes!

GOLD: I am including (page 5) my 13-week momentum chart for gold based on the ratio of the price of gold (weekly) against its price of 13 weeks ago. Momentum tends to precede price, and you can see from the down-arrow that the trendline of late-1973 to early-1974 was broken in mid-March, 1974. The momentum break was followed by the correction in gold which took the metal from a peak of $180 to the July 4 low of $129.

I spoke to a number of experts a few months ago regarding their view of gold. I was surprised (as I stated in Letter 610, page 6) at the number who were predicting a break below the $129 low. In the meantime, my momentum chart had turned up, and this is shown by the up-arrow in the early-July area. All of which prompted me to take a contrary position on gold, namely, I thought the $129 low would hold, and that the next move would be an approach to $160 and bettering $160 a try for the $180 high.



The last major rise in the 13-week momentum of gold took the ratios from 77 to 178. The most recent (July) rise started at almost the same level on the momentum scale. If gold builds up the same kind of momentum this time as it did on its last rise, we could have a most interesting move in bullion. Perhaps significantly, the current rise in my momentum line is timed so that it could carry upwards into the early months of 1975. I find this interesting because gold is "scheduled" to become legal on January 1.

A few interesting facets have been introduced into the gold picture since the last Letter. First, Merrill Lynch with 262 offices has teamed up with two other "little outfits" to sell gold bullion. I feel that Merrill has probably surveyed the picture with great care, and they have decided that there is going to be alot of brokerage money going into bullion.

Merrill Lynch, 2 Others Form a Gold Dealership

By a WALL STREET JOURNAL *Staff Reporter*

NEW YORK—Merrill Lynch & Co. is forming with two other concerns a jointly owned company to deal in gold and other precious metals.

Joining in the venture with the securities-firm holding company are Samuel Montagu & Co., a large London-based gold bullion dealer, and Handy & Harman, a metals fabricator headquartered in New York. The company, which will sell gold bars to the U.S. public, is to be called Merrill, Montagu, Handy & Harman.

For the first time in 41 years, U.S. citizens will be allowed to own gold starting next year. It is expected that several other securities firms will open gold dealerships.

A few of the super-iconoclasts are telling me that unless gold goes over $200 by legalization time (Jan. 1, 1975), the US Government will extend the timing for legalization ("They won't let 'em have it at these low prices"). In other words, they are saying that citizens will only be allowed to buy gold at the highs. My answer, I don't know, but if you feel that way, go out and buy Mexican (gold) pesos and Austrian coronas now. Personally, I see nothing wrong with this procedure, rather than waiting for "legal gold" on January 1. Just be sure you use a reputable dealer, do not margin your coins, and put them in your safety deposit box (you can even insure your safety box if you want — against fire, theft, etc.).

The next item involves the Kruggerand, which I spoke about in the last two reports. R.A.Plumbridge, president of the S. African Chamber of Mines informed a small group at Princeton two weeks ago that S. Africa is going to push its Kruggerand output up to 150,000 rands (each rand weighs an ounce) per week, starting around February or March. Information I have received from other sources inform me that S. Africa is planning to mint a 1/2 and a 1/4 Kruggerand. The picture is becoming increasingly clear to me, and this is the way I see it.

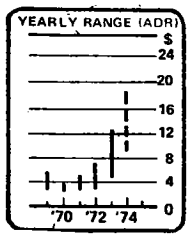
S. Africa is out to make itself invaluable to the Free World (which now pretends to scorn it, due to its racial policies). How will it do this? By producing the Free World's standard of real money, the Kruggerand, which I feel will be the most wanted form of gold in the world (since it will be a modern gold coin, legal tender in S. Africa at the market price of gold). Furthermore, I believe S. Africa has decided to go into a massive retail operation in gold, a move which is brilliant. S. Africa knows that hundreds of thousands of "little people" are going to buy the Kruggerands, then squirrel them away. This gold is going to disappear in back yards, under mattresses, into the walls, and off the market. All of which will tend to drive the price of gold up. It would not surprise me to see S. Africa end up by putting half to two-thirds of all newly mined gold into Kruggerands. I can't imagine a shrewder move from S. Africa's standpoint.

There is some consternation regarding shortages of labor at the S. African mines. I hate to sound hard-nosed, but before the next year is over, I believe S. Africa is going to have all the labor they want. Mozambique's economy is now collapsing, unemployment is rampant, construction, business, have come to a standstill. About 80% of Mozambique's external money comes from S. Africa. If Frelimo wants to rule, they are going to have to play ball with S. Africa, and they know it. That means labor from Mozambique. Any labor shortages at the mines, in my opinion, will be temporary.

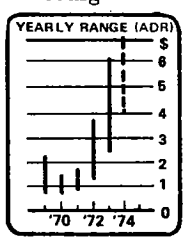
The gold shares have been backing and filling with none of them breaking below their recent (July) lows. A veteran Dow Theorist wrote me that he remembers during the 1929-32 crash that the gold shares sold off but each annual high-low held above the previous year's high-low. This kind of long-range action is often indicative of a primary bull market which remains intact (for instance, apply that test to the general run of stocks on the NYSE and see how many in 1974 have held above their 1973 lows and how many in 1973 held above their 1972 lows. The results will shock you).

I include (page 6) five typical S. African gold mining equities, each showing the annual high-low range to date. Note that since 1970 or '71 all have moved in annual ranges so that each successive year's high was above the previous year's high and each successive

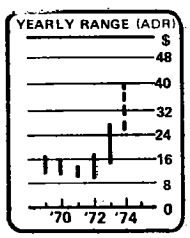
East Driefontein



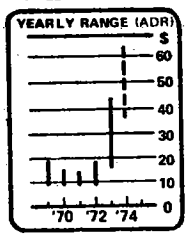
Elsburg



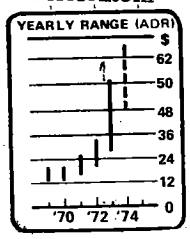
President Brand



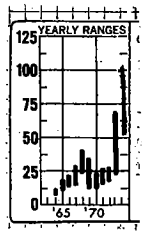
Vaal Reefs



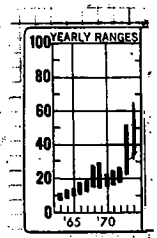
West Driefontein



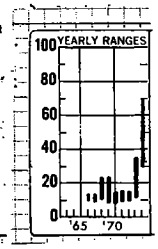
ASA



Dome



Homestake



annual low was above the previous year's low. This is most impressive, and the same test can be successfully applied to all the listed gold shares on the NYSE. I have included annual charts of Dome, ASA and Homestake.(S. African charts courtesy of Kaffir Chart Service, Palisades Park, NJ 07650).

S. African shares which I think look best here are Elsburg, West Driefontein, Free State Geduld, President Brand, Vaal Reefs.

NOTES & QUOTES: Try to get a copy of the Oct. 12 Business Week. Half the issue is devoted to an article entitled "The Debt Economy." It's an eye-opener.....I made the following montage from four articles out of the Oct. 15 Wall Street Journal, and one from our local paper. I mean this business contraction is coming on like gang busters. I believe that even Washington is beginning to smell the barn burning, and the money pumps are starting to churn. The dollar is turning quite weak now, with most of the other currencies moving up steadily against the greenback (almost all the major currencies have recorded strong upward zig-zags from their lows of early July. The weakening dollar (somebody besides me and my readers evidently knows we are trying to inflate) should be a bullish factor for gold, and probably ties in with the bullion momentum chart..... The bullion/gold share ratio (see last Letter, page 6) dipped slightly last week in favor of the shares.....Kuwait's oil minister stated last week the oil exporters would never reduce oil prices unless the West "starts to clean house inside and captures their own inflation." My view: oil prices will come down with everything else. Deflation, like a bear market, is very democratic, it includes everybody.

Sindona Paper Firm Puts Employes on 3-Day Week

VERONA, Italy—Saifecs di San Giovanni Lupatoto, a specialty paper and cardboard concern controlled by Michele Sindona, put

Mead Lays Off 375 Workers At Three Alabama Foundries

DAYTON, Ohio—Mead Corp. said it is laying off 375 of the 1,100 workers at three of

Volkswagen and Unit Again Cut Work Time Due to Slumping Sales

Special to THE WALL STREET JOURNAL

WOLFSBURG — The six West German plants of Volkswagenwerke AG, and the two

Yashica Plans to Close Camera Plant, Reduce Total Work Force 40%

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2,200 Hit By Layoffs At Admiral

CHICAGO (AP) — Admiral Corp. has laid off about 2,200 employes, more than a third of its television and radio manufacturing work force, the company said yesterday.

LATE MARKET NOTES: The Drew Odd Lot Studies service was taken over a few years ago by Bill Bretz, who is a top technician for my money. In his latest issue Bretz shows a three month average of odd lot buying and selling ratios going back to 1959. What is interesting is that the peak of odd lot selling (ratios) occurred in early 1971. Since then, there has been a steady trend towards less selling as the market worked lower. This is long-term bearish ("lower prices are bargains"). In fact, the three-month index last month dropped to its lowest level (least selling) since 1970. This kind of action is not characteristic of a major bottom.

On the other hand, the bellwether Utility Average has now pushed well above its Sept. 13, 1974, low of 57.93. The very important D-J 40-Bond Average has now climbed slightly above its all-time October, 1974, low of 64.13. These are positive developments, if they don't reverse themselves.

Bear market rallies can (and usually do) look more impressive than the real thing (the real thing being an advance in a primary bull market). But in the end, a bear rally is the optimist's downfall, the enlightened fund manager's gift from heaven (he can sell stock into it), and Wall Street's opportunity (business picks up as the traders and amateur bulls buy, while busted stockholders and "bail-out Charlies" sell).

Whenever a bear market (upward) secondary is underway, one hears the question, "How far is it going?" Only one answer (imperfect as it is) has withstood the test of time. This is Robert Rhea's observation that bear rallies tend to correct one-third to two-thirds of the previously uncorrected primary decline. According to this formula (if this is to be a full secondary), we might expect this advance to push to the 685-790 area. I'll add a second observation of my own. When this bear rally runs out of steam and starts fading, it's going to leave the usual number of in-and-out traders looking up at where they bought their stocks, with most of them wishing they had never tried to climb aboard. But that's the way great bear markets and explosive bear rallies work — they're out to get every last optimist (and in time they do).

A subscriber called to ask me, "How can the market rush up like this if we are moving into trouble on the economic front? " I told him that early 1930 (following the 1929 crash) saw one of the greatest upward secondaries of any bear market in history. The 1930 rise occurred a year or so before the nation slumped into the worst depression in its history.

Final observation (Oct. 16 before the close)....I dunno; this market keeps trying to rally back, but it keeps fading. Watch for a non-confirmation by Industrials or Transports if the Averages try to advance through the Oct. 14 highs (see page 1 chart).